22.03 Examples #1 & #2 at Date of Acquisition

Recording the Acquisition

When the acquirer records the transaction as an investment, recording the acquisition is quite straightforward. The Investment in acquiree is debited for the purchase price, meaning the total fair value of the consideration paid by the acquirer. Essentially, this is the balancing entry to offset the accounts being credited in the remainder of this entry. The book values of the acquiree accounts are ignored.

- Cash is credited for any amounts paid.
- Common stock is credited for the par value of any shares being issued by the acquirer.
- Additional paid-in capital is credited for the excess of the fair value of any shares being issued over their par value.

There is no entry to retained earnings since the acquirer does not retroactively combine the income of the acquirer in a purchase. The Acquiree's income is included from the date of acquisition (prospective, not retroactive).

Measurement Period & Measurement Period Adjustments

In some circumstances, the acquirer may believe that the measurement of the fair value of an acquiree, which is used to determine an appropriate acquisition price, is reliable, while the fair values of some of the individual identifiable assets acquired and liabilities assumed could not be reliably determined on a timely basis.

If the acquirer is required to prepare consolidated F/S *prior to* being able to obtain a more accurate measurement, the following procedures will be applied:

- The asset or liability for which a reliable fair value has not been determined will be recorded at management's *best estimate* based on information that is available with that amount referred to as a *"provisional" value*.
- As a result of using the provisional values, the amount reported as goodwill may be over- or understated, depending on the overstatement or understatement of the assets and liabilities recorded at their provisional amounts.
- Depreciation, amortization, interest income or expense, and other revenue and expense items that are affected by those values are recognized as if the provisional amounts are the actual fair values and the consolidated F/S are prepared accordingly.

The entity then has one year from the date of acquisition, referred to as the *measurement period*, to obtain a more reliable measurement. If management is unable to do so, the provisional amounts are accepted as the actual amounts and the items are accounted for as comparable items would be. Neither the items nor their I/S effects will be adjusted.

If, on the other hand, management can obtain a more reliable measurement, the following procedures will be followed:

- The assets or liabilities will be adjusted to the amounts that would have been their carrying values as of the balance sheet date if they had originally been recorded at their more reliable amounts.
- The I/S effects, including such items as depreciation and amortization expense, interest net of amortization of discount or premium, and other items that would have been affected by the change in carrying value will be recalculated as if the appropriate amount had been used on the date of acquisition.
    - Current period amounts are adjusted to reflect the correct amounts that would have been reported if the assets and liabilities had been originally recorded at the appropriate amount
    - Amounts related to prior periods were originally required to be accounted for as prior period adjustments, correcting items for the previous period, if comparative F/S are presented, and recording the net change as an adjustment to beginning retained earnings if only single period F/S are presented.
    - The adjustments to prior period I/S items are reported in the current period's I/S on a "catch up" basis.
        - They may be included with the current period's amounts with the amounts for the prior period disclosed in the notes to the F/S; or
        - They may be reported separately from the current period's amounts on the face of the I/S.

Preparing Consolidated Financial Statements

When the acquirer records the initial transaction as an investment, it will prepare consolidated F/S each reporting period. Preparing consolidated F/S involves a process under which:

- The investment is eliminated, as are the acquiree's (subsidiary's) equity accounts.
- Those assets and liabilities that were part of the original acquisition and are still on the books will be adjusted for differences between their book values and fair values on the acquisition date.
- The I/S effects of differences between book and fair values will be recognized in income to the extent that they apply to the current period and to retained earnings to the extent that they apply to prior periods.
- The effects of interentity transactions are eliminated.
- The noncontrolling interest will be recorded in equity based on the fair value on the date of acquisition adjusted for changes due to income or distribution since that date.

Pushdown Accounting

One of the more cumbersome aspects of preparing consolidated F/S is keeping track of the differences between the fair values and the carrying values of the acquiree's assets and liabilities at the acquisition date. Each period, until all of those items have been disposed of or settled, an adjustment will be required to recognize that difference as well as any depreciation, amortization, impairment, or other adjustment that would have been made to it since the date of acquisition.

GAAP provides an alternative in the form of pushdown accounting. When an acquiree decides to adopt pushdown accounting, it adjusts its assets and liabilities to the same amounts at which they will be reported by the acquirer (parent) and account for those assets and liabilities going forward on a basis similar to that which would be applied by the acquirer (parent). As a result, the

consolidation process is simplified and the acquirer (parent) will only be required to eliminate interentity transactions, recognize the noncontrolling interest, and eliminate the investment account.

An acquiree is not required to adopt the pushdown basis of accounting but may decide to do so in any period in which there is a change in control event. If, for example, an investor with the ability to exercise significant influence over an investee acquires additional equity resulting in a controlling financial interest, the acquiree could adopt pushdown accounting in that period.

- An election to adopt pushdown accounting is irrevocable.
- If an entity does not elect to adopt pushdown accounting in the period of a change of control event, it may do so in a subsequent period and will account for the change as a change in accounting principle.

Examples of Consolidations on Date of Acquisition

Class Example #1

Assume the following balance sheets are available for P Co. and S Co. at 12/31/X1:

Accounts	P Co.	S Co.
Cash	1,000	100
A/R		
Inventory		
Equipment (PP&E)	8,000	500
A/P		
Bonds Payable		
$1 CS	(1,000)	(100)
APIC	(3,000)	(100)
RE	(5,000)	(400)

If P issues 150 shares of stock to acquire all of S, and the stock being issued has a market value of $6 per share, the entry to record the acquisition is:

Investment in S	900	
Common stock		150
Additional paid-in capital		750

If the purchase were for an equivalent amount of cash instead, the entry would be:

Investment in S	900	
Cash		900

Notice that none of the information about the acquiree is needed, since an acquisition is recorded at the purchase price, not at the underlying equity of the acquiree. Also note that the entry is not affected by the percentage acquired.

Combining Equity

When consolidated F/S are prepared, the separate trial balances of the acquirer and acquiree are combined on a **worksheet** into a single set of numbers for presentation purposes. In the process, certain account balances must be eliminated or adjusted. This includes all accounts that treat the two companies as separate entities, since the presentation is designed to report them as a single entity. The consolidation process eliminates reciprocal items that are shown on both the acquirer's and acquiree's books. These eliminations are necessary to avoid double counting the same items which would misstate the F/S of the combined economic entity.

The concept of consolidated statements is that the resources of two or more companies are under the control of the acquirer. Consolidated statements are prepared as if the group of legal entities were one economic entity, based on the **economic entity concept**.

After an acquisition, the preparation of a consolidated financial statement requires substantial adjustments, since the investment has been recorded at the purchase price, not the underlying equity of the subsidiary.

The **entry to combine equity** includes all of the following elements:

- All of the equity accounts are debited to remove 100% of the acquiree account balances.
- Investment in acquiree is credited to remove the account.
- Investment is credited (for investments held prior to acquisition - Fair value of previously held equity interests in acquiree)
- Noncontrolling interest is credited (multiply the active market price on the acquisition date × the number of shares held by the noncontrolling parties)

If the fair value of net identifiable assets of the acquiree is *less than* the aggregate of the consideration transferred, plus the acquisition date fair value of previously held interests, plus the fair value of noncontrolling interest, **goodwill** is recognized.

If the fair value of net identifiable assets of the acquiree *exceeds* the aggregate of the consideration transferred, plus the acquisition date fair value of previously held interests, plus the fair value of the noncontrolling interest, then a bargain purchase occurs. A **gain** is recognized by the acquirer in the current period's I/S for the bargain purchase.

The calculation of Goodwill and Gain is as follows:

Fair value of consideration transferred (cost to the acquirer)
\+ Fair value of previously held equity interests in acquiree
\+ Fair value of noncontrolling interest
(–) Fair value of net identifiable assets of acquiree
Goodwill or Gain from bargain purchase

Goodwill is defined as "an asset representing the future economic benefits that arises from other assets acquired in a business combination that are not individually identified and separately recognized."

In addition, the entry will usually require adjustments to Identifiable asset accounts whose fair value differed from book value on the date of the original acquisition, and an entry for goodwill for the remaining difference in the entry. The following approach is needed:

- Assets that were sold prior to the balance sheet date are ignored.
- Identifiable Assets still being held at the balance sheet date are adjusted for the difference between the fair value and book value **at the date of Acquisition**.
- The other identifiable assets acquired, liabilities assumed, and any noncontrolling interest are measured at fair value. Any **newly identified intangible assets** of the acquiree must also be recognized.
- Any remaining **debit** necessary to balance the entry is recorded as **Goodwill**.
- If a **credit** is necessary (paid less than net Fair Value for Acquiree) the bargain purchase is recorded as a **gain** on the I/S.
  - Acquired assets and liabilities at **fair market value** (FMV). (Goodwill and FMV write-up)
    - Excess of FMV over BV considered FMV Increment (write up)
      - Land
      - PP&E
      - Inventory
      - Other Identifiable Assets (ID assets)

C/S	X	
APIC	X	
R/E	X	
ID Assets (to FMV)	X	
Goodwill	X	
Investment in Acquiree		X
Investments held prior to acquisition in Acquiree		X
Noncontrolling interest (@FMV)		X

100% of Acquiree

If an adjustment occurs to an asset which is **depreciable or amortizable,** an additional entry must be made to account for the depreciation or amortization between the purchase date and financial statement date. Intangible assets that do not have definite lives, such as **goodwill, will be tested for impairment** on an annual basis pursuant to ASC 350.

Class Example #2

Assume that P Co. acquired all (100%) of the stock of S Co. in an acquisition on 12/31/X1 for a payment of $900 cash. At the time, the book value of S was $600, and all of the assets and liabilities had fair values equal to their book values, with the exception of equipment with a remaining life of 5 years and a fair value $100 higher than book value. The accounts of the two companies at 12/31/X1 are presented in a worksheet, along with the combining entry.

Everything acquired @ **FMV** of stock given or cash paid:

Purchase price		$ 900	
FMV	FMV increment	$ 700	FMV Appreciation **equipment $100**
BV		$ 600	

Accounts	P Co	S Co	Debits	Credits	Consol
Cash	100	100			200
Equipment	8,000	500	100		8,600
Inv in S	900			900	--
Goodwill			200		200
$1 CS	(1,000)	(100)	100		(1,000)
APIC	(3,000)	(100)	100		(3,000)
RE	(5,000)	(400)	400		(5,000)

To acquire Investment: (In books)

Investment	900	
Cash		900

To consolidate: (On worksheet)

C/S	100		(100%)
APIC	100		
R/E	400		
Equipment	**100**		
Goodwill	**200**		
Investment		900	

Goodwill is the balancing entry in the above: it represents the excess of the $900 investment over the $700 fair value of the net identifiable assets ($600 book value + $100 excess of fair value over book value of equipment = $700).